



BUREAU OF COMPETITION

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

**COMMISSION
APPROVED**

9874643

MAR 11 1937

The Honorable Juanita D. Miller
Economic Matters Committee
House of Delegates
Annapolis, Maryland 21401-1991

Dear Delegate Miller:

The Federal Trade Commission staff is pleased to respond to your invitation for comments on the proposed "Wine Cooler Fair Dealing Act," a bill that would regulate business arrangements between suppliers and wholesale distributors of wine coolers.¹ We recommend against passage of this bill because it will introduce rigidity into the distribution system for wine coolers and ultimately raise prices to consumers.

Congress has charged the Commission with enforcing the nation's antitrust and consumer protection laws. Under this mandate, the Commission or its staff has frequently appeared before other governmental bodies to help assess the competitive and consumer welfare implications of pending issues. The Commission is particularly familiar with competition issues in the distribution of alcoholic beverages. On various occasions in recent years, the Commission staff has presented its views on

¹ These comments represent the views of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission and do not necessarily represent the views of the Commission or any individual Commissioner. The Commission, however, has authorized the submission of these comments.

proposed legislation governing the sale of these products.²

Likely Effect of the Wine Cooler Fair Dealing Act

1. Distribution Arrangements

The Wine Cooler Fair Dealing Act requires the supplier to provide its wholesale distributor with a written agreement designating a specific sales territory, § 203.3(9) (see also Section 203.22(A))³ and provides that a distributor "may not sell or deliver wine coolers to a retail licensee located outside the sales territory designated by the supplier" § 203.4(A)(1). This requirement prevents the supplier from selecting what it considers to be the most efficient distribution system, and limits the supplier's ability to respond quickly to changing market conditions. Moreover, the enforcement provisions shift unnecessarily the balance that would otherwise exist between the supplier and the distributor under existing principles of tort and contract law. By preventing the supplier from choosing the way it thinks best to get its product to consumers, the Act is likely to increase the price to the consumer.

No reason exists to impose inflexible vertical arrangements between suppliers and distributors by legislation. Vertical restraints imposed by suppliers can operate as procompetitive and efficiency enhancing arrangements, which will withstand antitrust scrutiny. However, in some circumstances, certain vertical

² See, e.g., Comments of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission on the District of Columbia Beer and Spirits Franchise Act (Aug. 29, 1986); Comments of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission on the California Beer Distribution Bill, Senate Bill No. 1211 (July 2, 1985); Comments of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission on the Rhode Island Distilled Spirits and Vinous Beverages Fair Dealing Law (Apr. 3, 1985); Comments of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission on (Virginia) House Bill No. 1301, Wine Franchise Act (Feb. 8, 1985); Malt Beverage Interbrand Competition Act: Hearings on S. 1215 Before the Senate Comm. on the Judiciary, 97th Cong., 2d Sess. (1983).

³ The supplier could assign more than one distributor to a territory. § 203.22(C).

restraints can operate to impede competition, in which case they will not withstand antitrust scrutiny. The activities of a competitive marketplace and the enforcement of the antitrust laws will deter and eliminate anticompetitive restraints. If Maryland chooses to mandate certain vertical arrangements, the legislation may lead to anticompetitive effects, thereby increasing costs to consumers.

2. Franchise Arrangements

With certain exceptions (see §§ 203.11-203.13), a supplier may terminate, fail to renew, or refuse to continue under an agreement with a distributor only for "good cause." § 203.7. The bill spells out what constitutes good cause and places on the supplier ending the agreement the burden of showing that the supplier acted in good faith and with good cause and that it complied with the applicable notice requirements of the bill. §§ 203.8, 203.9. These restrictions would make it difficult for suppliers to maintain efficient distribution systems. The need to have "good cause" for not renewing a particular agreement (§ 203.7) could prevent suppliers from reacting quickly and efficiently to changes in supply and demand conditions.⁴ Thus, suppliers might be unable to restructure distributional networks that have become obsolete, since their distributors' conduct might comply with the original agreement.

Furthermore, the bill also restricts the supplier's ability to withhold its consent to any transfer of the distributor's business if the proposed transferee meets the material and reasonable qualifications and standards required by the supplier. § 203.15. "Reasonable qualification" is defined as the average standard of the criteria used by the supplier for distributors that entered into or renewed an agreement with the supplier during the prior two years. § 203.2(H). If the proposed transferee is the distributor's heir, the supplier may not interfere at all with the transfer of the distributor's business under certain circumstances. §§ 203.2(D), 203.15(D). These provisions would enable distribution arrangements to survive long after the original distributors had gone out of

⁴ Under the bill, "good cause" is basically a failure by the distributor to comply with a provision of the agreement that is both reasonable and of material significance to the business relationship with the supplier. § 203.8. Even when the supplier can establish the requisite noncompliance, the distributor has 165 days to take corrective action and cure its noncompliance. § 203.8.

business. The higher costs caused by these inefficiencies would undoubtedly be passed on to consumers.

It is likely that some current distributional networks will, in fact, become outmoded within the next five years. Published reports indicate that wine coolers first appeared in the United States in 1981. Today there are more than 100 brands of wine coolers in the market. This product, which was not available seven years ago, now accounts for annual sales of more than \$1 billion. Companies have been entering (and in some cases exiting) this booming market at a rapid rate.⁵ In such a market, distribution technologies and patterns are likely to change relatively rapidly. A law that failed to allow this change would impose significant costs on consumers.

The Wine Cooler Fair Dealing Act may have its greatest impact on suppliers whose distributors have already been allotted exclusive sales territories that, taken together, cover the entire state. Since the bill prohibits the supplier from failing to renew an agreement or refusing to continue under an agreement except under certain circumstances (see §§ 203.7-203.8), once a supplier assigns an exclusive sales territory to a distributor, the supplier, despite § 203.22(C), may not be able to create new distributorships in that territory without challenge from the existing distributor for terminating or reducing the sales territory.

As a result of the proposed statutory scheme, suppliers may find it difficult to improve their distribution networks by introducing additional distributors. Even though a supplier may have a legitimate and procompetitive business reason for wanting to reduce or eliminate a distributor's territory, the supplier may be reluctant to face the threat of a court battle and incur the cost of proving the existence of "good cause." A supplier faced with a number of poorly performing distributors may find it

⁵ Jobson's Wine Marketing Handbook 1986 (D. Hecht ed. 1986); New Coolers Draw Lukewarm Response, Wall Street Journal, Feb. 20, 1986, at 27; Another Coup for the Fighting Gallos, New York Times, July 6, 1986, § 3, at 1, 22; Bartles & Jaymes Winning Fierce Fight for No. 1, Advertising Age, Oct. 6, 1986, at S-2; Regionals Scramble for 10% of Market, Advertising Age, Oct. 6, 1986, at S-4; Brewers Bottle Up Their Entry's Double Identity, Advertising Age, Oct. 6, 1986, at S-6; Predict Big Chill for Wine Coolers, Advertising Age, Aug. 11, 1986, at 23; Cooler Crowd Fells Coors, Schenley, Advertising Age, Feb. 24, 1986, at 3, 83.

especially difficult to establish "good cause," since "good cause," as defined in § 203.8 of the bill, is not necessarily satisfied by demonstrating a sales performance inferior to that of other distributors of the same brand. The distributor is required to maintain only "reasonable sales levels." § 203.14.

In the absence of regulation, suppliers can always rely on the possibility of bringing in new distributors to ensure that retailers receive adequate supplies of their wine coolers at competitive prices. If the existing distributors attempt to charge above the competitive price, suppliers can give franchises to new distributors that are willing to charge lower wholesale prices. Suppliers can also sell through distributors from other territories. By interfering with possible entry into the territory, the Wine Cooler Fair Dealing Act may thereby increase the prices paid by consumers.

The Act will interfere unnecessarily with market forces by increasing the supplier's costs of switching from one distributor to another or adding additional distributors. The stimulus to efficiency in distribution resulting from competition for the supplier's patronage among existing and potential distributors will be reduced as it becomes more costly for suppliers to change or add distributors. These higher costs will also reduce the incentives of existing suppliers to introduce new brands into Maryland and of new suppliers to enter the market.

3. Prohibitions on Exclusive Dealing

Another potentially cost-enhancing provision of the Act is Section 203.3(4). This section prohibits a supplier in most cases from requiring a distributor "to assent to any condition, stipulation, or provision limiting the right to sell the brand or brands of wine coolers of any other supplier" § 203.3(4). This prohibition imposes costs of its own. An exclusive dealing arrangement could be of considerable value to a supplier that finds it difficult to monitor the efforts that its

distributors are making on behalf of its products.⁶ By confining a distributor to the supplier's products, the supplier ensures that it is in the distributor's own interest to market those products aggressively. Such a contract clause does not unfairly burden the distributor or call for governmental intervention, unless the firms imposing the contracts had substantial market power and distributors could not readily turn to alternative suppliers. In a competitive market, a supplier could not force such unilateral terms on a distributor to the detriment of the latter, since the distributor could turn to other suppliers. Rather, a supplier would have to induce a distributor to agree to an exclusive dealing arrangement by offering the distributor something in return, such as lower prices or a promise to fill all of the distributor's needs.⁷ Whatever the inducement, the distributor would obtain cost savings that could be passed on to consumers in the form of lower prices.

In the absence of a restrictive provision like Section 203.3(4), both a supplier and a distributor could benefit from a long-term contract under which the distributor agreed to deal exclusively in the supplier's products, and the supplier agreed to fill all of the distributor's orders. The distributor would have bargaining power to gain protection from the possibility of being cut off by the supplier after the distributor had invested considerable resources in its marketing effort. The supplier would not have to worry about the distributor suddenly shifting its efforts to other brands, leaving the supplier without a reliable outlet in the area.⁸ Likewise the supplier would encourage the distributor to expend the effort to develop demand

⁶ See R. Posner & F. Easterbrook, Antitrust: Cases, Economic Notes, and Other Materials, 886 (2d ed. 1981). Such arrangements are lawful under federal antitrust law unless their effect "may be to substantially lessen competition or tend to create a monopoly in any line of commerce." 15 U.S.C. § 14 (1982); see Standard Oil Co. v. United States, 337 U.S. 293 (1949). [While the quoted language is from Section 3 of the Clayton Act, the exclusive dealing doctrine that the courts apply under the Sherman Act is essentially the same. See R. Bork, The Antitrust Paradox, 299 (1978).]

⁷ R. Bork, The Antitrust Paradox, 309 (1978).

⁸ See R. Posner & F. Easterbrook, Antitrust: Cases, Economic Notes, and Other Materials, 886-87 (2d ed. 1981) ("long term exclusive dealing contracts may be an effective way of dealing with opportunistic behavior").

for the brand, by displaying the commitment to provide enough product to meet the demand created. Prohibiting such arrangements could increase the risks of both suppliers and distributors and thereby add to the costs of distribution, costs that would be borne by consumers.

Conclusion

According to Section 203.1(A) of the bill, the Wine Cooler Fair Dealing Act is designed, among other things, to promote temperance, encourage wholesale distributors to make investments in their facilities by protecting them against the termination of their distributorships, and encourage fair competition in the sale of wine coolers. In fact, the bill is special interest legislation. It would harm consumers who would be forced to pay the higher prices caused by the protection of inefficient distributors from new entrants, and the preservation of obsolete distributional arrangements.

If the Legislature is interested in raising prices for wine coolers in order to promote temperance, a tax is a much more direct way to attempt to achieve that goal. The Legislature could discourage wine cooler consumption with a sales tax, which would allow the State, not suppliers or distributors, to capture the extra revenue produced by higher prices.

In the absence of the Wine Cooler Fair Dealing legislation, competition will compel wine cooler suppliers to maintain the most efficient, lowest-cost distributional arrangements, to choose the most efficient methods of marketing products, and to retain necessary flexibility to respond effectively to shifting consumer preferences and demand patterns.

By substituting regulation for the forces of the marketplace, the Act would protect individual distributors at the

⁹ Section 203.3 also imposes other restrictions on the requirements that suppliers can impose on their wholesalers. Like the exclusive dealing restriction of Section 203.3(4), some of these restrictions could lead to increased distribution costs.

The Honorable Juanita D. Miller

-8-

expense of higher prices to consumers. The Commission staff therefore recommends against enactment of the Wine Cooler Fair Dealing Act.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Jeffrey I. Zuckerman". The signature is fluid and cursive, with a large initial "J" and "Z".

Jeffrey I. Zuckerman
Director